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Diversifying Diversification

INTERVIENE

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ABSTRACT

Diversification is a core concept in Asset Management. Yet, this term can mean different things to different people and there is no general consensus on how it is measured nor there is a broadly accepted metric for its reporting.

In this paper, we propose a new index to measure the diversification of a portfolio. Specifically, we outline a two-dimensional risk decomposition of the portfolio volatility that it is the basis to calculate our new quantitative diversification index QDX. The index takes values in the range $[0,1)$, with the extremes signalling lack of or perfect diversification. The appealing features of our measure are its simplicity in the computation, given that it only requires the covariance matrix and the portfolio allocation and does not involve any optimization, and its clear interpretation. It has also a clear interpretation. We also provide a mathematical rationale for our QDX index, so that it can be easily extended to homogeneous risk measures.

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